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In the Supreme Court of the United States

OCTOBER TERM, 1958.

No. 585.

NICHOLAS FERRAIOLO,
Petitioner,

v.

F. R. NEWMAN,
Respondent.

BRIEF OF RESPONDENT.

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OPINIONS BELOW.

The opinion of the Court of Appeals for the Sixth Circuit (App. to Pet. for Cert., p. 22) is reported in 259 F. 2d 342. The opinion of the District Court for the Northern District of Ohio (Joint App., p. 40a), which was affirmed on appeal, is reported in 163 F. Supp. 506.

STATUTE INVOLVED.

The pertinent provisions of the Securities Exchange Act of 1934 are set forth in the Appendix, *infra*, page 15. Section 16(b) of that Act, 15 U. S. C. § 78p(b), provides, in so far as here pertinent, that any profit realized by a director from any "purchase and sale" of exchange-listed stock of his corporation "within any period of less than six months * * * shall inure to and be recoverable by the issuer * * *." There is no definition of "purchase" in the Act except that provided by § 3(a)(13), 15 U. S. C. § 78(a)(13): "The terms 'buy' and 'purchase' each *include* any contract to buy, purchase, or otherwise acquire." (Italics supplied.)

QUESTION PRESENTED.

Was the conversion of a convertible preferred stock into common stock a "purchase" within § 16(b) when (1) an increase in the market price of the common above the redemption price of the preferred had caused the market price of both preferred and common (when adjusted to reflect the conversion ratio) to be the same for more than ten months preceding the conversion, and (2) more than 99% of all the outstanding preferred was converted in order to avoid its being redeemed at some $9 per share below its market price?

STATEMENT.

1. The Statutory Scheme.

Section 16 of the Securities Exchange Act of 1934 was the answer of Congress to the abuses with respect to "insider trading" which had been exposed by the Senate investigation.[1] Section 16(a) requires every director or officer of a company having an equity security registered on an exchange, as well as every beneficial owner of more than ten percent of any equity security so registered, to file monthly reports with respect to any change in his holdings of any equity security of the same issuer. Section 16(b) provides for the automatic recapture, by the issuer or by any security holder suing on the issuer's behalf, of any profit realized by any such director, officer or ten percent owner from "in-and-out trading" in any equity security of his company within a period of less than six months. The test in § 16(b), in marked contrast to that in § 16(a), is "purchase and sale" rather than "any change in such [beneficial] ownership."

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[1] For a general discussion of § 16(b), see Loss, Securities Regulation (1951 with 1955 Supp.) 561-98.

Section 16(b) was described by the Administration's principal spokesman for the 1934 bill as a "crude rule of thumb."[2] If the period which elapses between a director's "purchase" and "sale" is six months less a day, he is liable without regard to any showing of either the existence or an actual abuse of inside information. Conversely, a director who holds for six months or more is not liable under § 16(b), no matter how much proof is adduced of unfair resort to inside information.

Everything turns, therefore, on whether there is a "purchase" followed by a "sale" within a period of less than six months. It is entirely beside the point to inquire whether there was "inside information," whether it was used or abused, or whether it might have been so used. In the ordinary, classic case of cash purchases and cash sales there is nothing to litigate. Obviously the case at bar is not a classic purchase. It is an extremely rare situation and arises solely because Respondent, a director, sold common stock on the market within less than six months after he, as well as all other holders of convertible preferred stock, had been *forced* to convert to common because the issuer had called the preferred for redemption at a time when both preferred and common were selling on the market at $9 above the redemption price of the preferred.

2. Facts.

The facts—which are not in dispute—are simple enough:

Convertible preferred (hereafter referred to as preferred) and common shares of Ashland Oil and Refining

[2] 15 Stock Exchange Practices, Hearings before Senate Committee on Banking and Currency, 73d Cong., 2d Sess. (1934) 6557.

Company were acquired by Respondent in 1948 in the course of a merger into Ashland of another company in which Respondent had been one of the principal shareholders. The preferred, which was created at that time, was listed on the New York Stock Exchange, where the common had already been listed. Since the conversion privilege of the preferred was fully protected against dilution, the declaration, in May 1951, of a ten percent stock dividend on the common entitled each share of preferred to 1.1 shares of common on conversion.

The redemption price of the preferred was $27 per share. By January 5, 1951, the market price of the common had climbed above $27. When this phenomenon occurs, it is axiomatic in the world of finance that the preferred (after adjustment for the conversion ratio) becomes the economic equivalent of common. The market price of the preferred will not rise above the market price of the common because of the lower redemption price. Nor will the market price of the preferred ever fall below that of the common, because it can always be converted into common even though it is called for redemption. In other words, the process of arbitrage will keep the market price of the two securities "locked together" until the company sees fit to force conversion of the preferred by calling it for redemption.

Precisely that happened in this case. Desiring to be rid of the preferred stock so that it would be free to raise additional capital through the issuance of a new series of convertible preferred, the company called the preferred for redemption on December 17, 1951, at which time the adjusted market price of the common was some $9 higher than the redemption price of the preferred. The holders of more than 99% of the preferred, including Respondent, converted, and within the next few months Respondent

sold common stock on the market at prices higher than the "locked together" market price of both preferred and common on the date of conversion. (Joint App., pp. 19a-21a.)

ARGUMENT.

1. There Is No Conflict With the Opinion of the Second Circuit in the Only Other Conversion Case.

Park & Tilford, Inc. v. Schulte, 160 F. 2d 984 (2d Cir.), cert. denied, 332 U. S. 761, the only other conversion case under § 16(b), was correctly distinguished by the court below in a number of vital respects:

(a) Here, Respondent's conversion was genuinely "forced." The real effect of the call for redemption was simply to force the surrender of the preference features of the preferred (App. to Pet. for Cert., p. 27). In *Park & Tilford*, by contrast, the defendants' control of the company was so pervasive that—as Judge Clark himself pointed out in *Roberts v. Eaton*, 212 F. 2d 82, 85 (2d Cir.), cert. denied, 345 U. S. 827, in distinguishing his earlier opinion in *Park & Tilford*—Schulte could "work his will through the board of directors." Hence, in *Park & Tilford* the court concluded that "the contention that defendants were forced to convert is somewhat absurd * * *." 160 F. 2d at 988.

(b) In *Park & Tilford* "the insiders exchanged non-marketable preferred shares for marketable common stock which was 'more valuable' " (App. to Pet. for Cert., p. 27). Here, in contrast, "Once the market price of the common stock rose above the redemption price of the preferred, the preferred, with its undilutable conversion privilege, became, in the objective judgment of the market place,

the economic equivalent of the common. * * * the conversion worked no material change in the proportional equity ownership of Ashland." (App. to Pet. for Cert., pp. 26-27.)

(c) The convertibility of the Park & Tilford preferred was not protected against dilution. Here, it was fully protected. Indeed, it seems fair to say that preferred stock which is not so protected is not a genuinely convertible preferred, and that it would probably violate the fraud provisions of the securities statutes to represent such a stock as "convertible" without a clear indication that the conversion privilege was not protected.

Judge Stewart (as he then was) might have gone further and observed that, in *Park & Tilford*, the call and conversion had all been part of a scheme of the Schultes to profit by converting the closely held preferred, which could not be sold to the public because it had no market and would have had to be registered under the Securities Act of 1933, into common which was already listed on a stock exchange and had an established market, and then unloading the readily marketable common on a public which had been led to run up the price of the common through a Schulte-inspired rumor that the board of directors would declare a dividend payable in whiskey.[1]

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[1] On December 15, 1943, Schulte had publicly announced that Park & Tilford was contemplating a distribution of whiskey to its shareholders at cost. (One must remember the whiskey shortage at that time.) The stock advanced from 57⅜ on that day to a high of 98¼ on May 26. On May 26 the company offered to sell to its stockholders at a reduced price six cases of whiskey for each share of stock. On May 31 the Office of Price Administration limited the negotiability of the purchase rights and the maximum profits on the resale of the liquor. The price of the stock dropped 10⅛ points that day and reached a low of 23⅝ in August. On December 20, 1943, the company served notice of redemption of its preferred stock; on January 19, 1944, the defendants, who owned some 91% of the outstanding stock

To be sure, Judge Clark did state in *Park & Tilford*: "We think a conversion of preferred into common stock followed by a sale within six months is a 'purchase and sale' within the statutory language of § 16(b)." 160 F. 2d at 987. But he was addressing himself to the facts of the particular case then before the court, which was only the second appellate decision anywhere under § 16(b) and the first to involve the meaning of "purchase" or "sale." Even so, Judge Clark was careful to ground his rejection of the Schultes' "forced conversion" theory on the fact that they were in complete control of the company. Putting to one side and reserving for future consideration the case of a genuinely forced conversion, he said: "Whatever might be the considerations involved in that situation, it is clear that here the defendants were not forced to convert * * *." 160 F. 2d at 987-88.

Since *Park & Tilford*, the courts have had to deal with the applicability of § 16(b) to the issuance of stock purchase rights or warrants, which they have held may or may not involve a "purchase",[1] to an exchange of securities with a subsidiary, which may or may not involve a "sale" of the securities transferred to the subsidiary depending upon whether the subsidiary is wholly owned at

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(Continued):

converted their preferred into common; and from December 15, 1943, to June 1, 1944, they sold approximately 93,000 shares of common. These facts are related in the Weeks affidavit, ¶ 17 *et seq.* and Ex. G. That portion of the Weeks affidavit was based largely on the Commission's opinion in *Ira Haupt & Co.*, 23 SEC 589 which was referred to by Judge Clark in the *Park & Tilford* case (160 F. 2d at 990-91) as showing "the nature of the evidence which a trial would bring forth."

[1] *Shaw v. Dreyfus*, 172 F. 2d 140 (2d Cir.), cert. denied, 337 U. S. 907 (not a "purchase" when issued to a director on the same basis as other stockholders); *Truncale v. Blumberg*, 80 F. Supp. 387 (S. D. N. Y.) (issuance of incentive warrants to an officer pursuant to an employment contract *is* a "purchase").

the time; and to a corporate merger, which may involve a "purchase" although the same result does not necessarily follow in the case of a stock reclassification. In each case the decision turned upon the facts of the particular situation before the court.

By 1954, when the Second Circuit held that a reclassification of common into a new preferred and new common did not involve a "purchase" of the new preferred, Judge Clark stated that the court was "not inclined at this juncture to attempt enunciation of a black-letter rubric." 212 F. 2d at 85. That is to say, it is impossible in the light of the statutory purpose to declare that *all* mergers or *all* reclassifications—or *all* conversions—either do or do not come within § 16(b). Instead, the common thread running through all these cases, including the opinion below, is whether, in Judge Stewart's words, the circumstances were such as to create an "opportunity for profit" which had not existed before, so that it might "reasonably be defined as a purchase," or whether the transaction was "one that could have lent itself to the practices which Section 16(b) was enacted to prevent" (App. to Pet. for Cert., pp. 25, 28).

Mr. Justice Harlan has recently seen fit to remind the Bar that "differences between the Courts of Appeals in two or more circuits will not be accepted as a conflict if they can fairly be accounted for on the basis of variations in the factual situations among the cases involved." Harlan, *Manning the Dikes—Some Comments on the Statutory Certiorari Jurisdiction and Jurisdictional State-*

Blau v. Mission Corp., 212 F. 2d 77 (2d Cir.), cert. denied, 347 U. S. 1016.

Blau v. Hodgkinson, 100 F. Supp. 361 (S. D. N. Y.).

Roberts v. Eaton, 212 F. 2d 82 (2d Cir.), cert. denied, 348 U. S. 827.

ment Practice of the Supreme Court of the United States, 13 Record of Assn. of Bar of City of N. Y. 541, 552 (1958). The only resemblance between *Park & Tilford* and the case at bar is that both involve conversions. Respondent has always accepted *Park & Tilford* as correctly decided. It was carefully distinguished below. There is no conflict

2. The Case Was Correctly Decided Below.

First: Since it manifestly will not do to say that *all* conversions, mergers, reclassifications, issues of stock purchase rights, and the like either do or do not involve "purchases," the courts have developed a test in terms of the statutory purpose. Cf. *SEC v. Ralston Purina Co.*, 346 U. S. 119, 124-25: "The natural way to interpret the private offering exemption [in the Securities Act of 1933] is in light of the statutory purpose: Since exempt transactions are those as to which 'there is no practical need for [the bill's] application,' the applicability of § 4(1) should turn on whether the particular class of persons affected needs the protection of the Act." So, in interpreting § 16 the courts generally (including both the lower courts in this case) have carefully distinguished, in the various situations not involving a classic purchase or sale, between those which in statutory context have the same economic attributes and consequences as a purchase or sale and those which do not. They pay no attention to whether the director did in fact have or use inside information, which is irrelevant, but consider whether the circumstances of the particular case were such that, assuming the possession or use of inside information, he could have obtained an advantage over the public generally which did not already exist. Thus, in *Roberts v. Eaton*, 212 F. 2d 82, 86, cert. denied, 348 U. S. 827, the Second Circuit concluded:

"The reclassification at bar [a reclassification of common stock into common and preferred by a class vote of stockholders so that a better price could be obtained on sale of the preferred to institutional investors who would not be interested in buying common] could not possibly lend itself to the speculation encompassed by § 16(b)." Again, in *Shaw v. Dreyfus*, 172 F. 2d 140, 142 (2d Cir.), cert. denied, 337 U. S. 907: "'Inside' information which the directors may have cannot possibly be used to the detriment of other stockholders in voting to grant rights to all stockholders of record in proportion to their existing holdings; all are treated equally." And in *Falco v. Donner Foundation, Inc.*, 208 F. 2d 600, 604 (2d Cir.): "Indeed, arbitrage is so clearly divorced from the abuses which § 16(b) seeks to prevent that an implied exception could be urged with some force even absent the express provisions of § 16(d) [exempting arbitrage]." In short, *cessante ratione cessat ipsa lex*.

Second: There was no conceivable opportunity for Respondent to use inside information in determining whether to convert in order to avoid a loss of $9 per share on the call for redemption. No person, unless he were out of the country or unable to act, would have permitted redemption. If the company had called the preferred when the common had been selling *below* the redemption price, the normal economic compulsion would have been for public stockholders to let their shares be redeemed and a director with inside knowledge of favorable future developments might have elected to convert. But that is not the situation here, as shown by the fact that more than 99% of the preferred stockholders acted as Respondent did. As Judge Clark stated for the Second Circuit in *Roberts v. Eaton*, 212 F. 2d at 85: "Nor can it

be gainsaid that like treatment of all stockholders will in most cases remove the possibility of abuse."

Third: It is true, of course, that Respondent may have had the benefit of inside information in determining when to sell his common stock after the conversion. But, apart from the fact that the market in the common continued to go up after his sales, this possibility is irrelevant and question-begging. For, if there had been no conversion and Respondent had sold the preferred shares which he had held for several years, there would have been no cause of action under § 16(b) regardless of how much inside information he might have had.

Moreover, it is no answer to say that a director in Respondent's position could always sell the preferred instead of converting. Suppose he had happened to buy preferred stock in the market at a lower price for investment purposes within the preceding six months. He would have to turn the profit over to the company even though he had been powerless to prevent the call for redemption which had forced on him the Hobson's choice of converting or selling.

Again, if a conversion is a "purchase" of common, presumably it is also a "sale" of preferred, which under Petitioner's view would have to be matched against any market purchase of preferred within six months before or after the conversion. No director could ever buy preferred or sell common without the risk that a forced conversion within the next six months would subject him to severe liability. Surely this was not the purpose of Congress when it attacked the problem of "in-and-out trading."

Fourth: Under the circumstances of this case, the conversion was no more significant than an exchange of a certificate for 200 shares of common into two certificates

of 100 shares each. To quote once more from a § 16(b) opinion of Judge Clark, on whom Petitioner relies so heavily, "for all practical purposes a convertible bond is equivalent to the number of shares of stock into which it is convertible." *Falco v. Donner Foundation, Inc.*, 208 F. 2d 600, 603, n. 2 (2d Cir.). Both the purpose and the effect of the anti-dilution provisions here were to preserve to every preferred shareholder his inviolable right to share in the growth of the company on a proportionate basis fixed at the time when the preferred stock was created, and to assure every preferred shareholder that the preferred could never have a value *less* than the value of the common into which it was convertible. The important factor in the context of § 16(b) is equivalence from the standpoint of opportunity to profit through trading, not from the standpoint of preferences in dividends or liquidation. For trading purposes, the preferences lost all value once the market price of the common had risen above the redemption price of the preferred. In economic reality, Respondent sold only that (less the preferences) which he had owned since 1948. To put it differently, the *only* reason that the preferred had a higher market value than its redemption price was the privilege of conversion; no one would have paid Respondent $36 for the right to get $27 on redemption.

Fifth: Since the statute does not define the term "purchase," it has its ordinary meaning in the field to which the legislature was addressing itself—in this case, the field of securities and investment banking—at least when this meaning does not produce a result inconsistent with the general statutory purpose. Petitioner introduced no evidence to counter the affidavits of three investment bankers (Joint App. 29a, 33a, 38a) to the effect that conversion of a fully protected, convertible preferred into

common stock under the circumstances of this case is not regarded as a purchase of common in "the investment, financial and business world."

Sixth: Petitioner's construction would result in recovery under § 16(b) when the use of inside information could not possibly have created a new opportunity for profit, but would raise a serious question as to the applicability of § 16(b) to a *market* purchase of *preferred* followed by a *market* sale of *common* (or vice versa) within a period of less than six months—a classic situation for potential abuse of inside information. Respondent's construction, on the other hand, by treating a fully protected convertible preferred and the common as economic equivalents, would facilitate the application of § 16(b) to such a situation, in which it is most needed.

Moreover, since Petitioner concedes that Respondent would not have been liable if he had responded to the call by selling the preferred which he had held for several years instead of converting it into its economic equivalent and then selling common a few months later, Petitioner's construction would exalt form over substance notwithstanding Judge Clark's admonition in *Blau v. Mission Corp.*, 212 F. 2d 77, 80 (2d Cir.), cert. denied, 347 U. S. 1016, that "undue stress" must not be put on formality so as to reach "harsh and wooden results quite unnecessary to achieve the purposes of the act."

3. There Is No Question of Federal Law Sufficiently Important to Warrant Supreme Court Review.

First: The most significant statement in the Petition for Certiorari will be found on page 20, where Petitioner concedes that "the Court of Appeals drew the correct rule out of the cases but failed to apply it to the facts

of this case." To quote once more from Mr. Justice Harlan's Cardozo Lecture (*supra* at 553), the case is not one for the Supreme Court even if the issue is "a 'just' result to [the] client under what may well be a 'better view' of the law." *A fortiori* this Court does not sit as a second reviewing court when all that is involved is the question whether the first reviewing court failed to apply a concededly correct rule of law to the facts of the particular case. It is also not without significance that all four judges who sat on this case reached the same result.

Second: This is only the second conversion case in the twenty-five years which have elapsed since § 16(b) has been on the books. Particularly since Petitioner concedes that the court below drew the correct general rule out of the cases, the applicability of that rule to conversions effected under varying fact circumstances is not a sufficiently recurring question to warrant Supreme Court review.

CONCLUSION.

The decision below is correct. It is conceded by Petitioner that the court below correctly determined the law. There is neither conflict nor need for further review. Accordingly, the petition for a writ of certiorari should be denied.

Respectfully submitted.

LOUIS LOSS,
JAMES A. WEEKS,
Counsel for Respondent.

February, 1959.

APPENDIX.

Securities Exchange Act of 1934, § 3(a)(13), 15 U. S. C. § 78c(a)(13):

(13) The terms "buy" and "purchase" each include any contract to buy, purchase, or otherwise acquire.

Securities Exchange Act of 1934, § 16, 15 U. S. C. § 78p:

(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security or within ten days after he becomes such beneficial owner, director, or officer, a statement with the exchange (and a duplicate original thereof with the Commission) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, shall file with the exchange a statement (and a duplicate original thereof with the Commission) indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable

by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

* * *